UNITED NATIONS

TD

United Nations Conference on Trade and Development

Distr.
GENERAL

TD/B/COM.2/ISAR/16/Add.4
9 August 2002

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Commission on Investment, Technology and Related Financial Issues
Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting
Geneva, 25–27 September 2002
Item 4 of the provisional agenda

ACCOUNTING BY SMALL AND MEDIUM-SIZED ENTERPRISES *

Report by the Ad Hoc Consultative Group of Experts on Accounting by Small and Medium-Sized Enterprises

* Submission of this document was delayed as a result of the need for further consultations with members of the ad hoc consultative groups.

GE.02-51491

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Accounting and Financial Reporting for Guidance for Level 3 Small Enterprises

I. Introduction

1. Level 3 guidance and financial statements are designed for small enterprises that are owner-managed and have few employees. Such enterprises should follow a simple accruals-based accounting system that is closely linked to cash transactions, and with a derogation for businesses to use cash accounting for a limited time when establishing their accounting systems. This guidance is consistent with the guidance for Level 2 (as set out in TD/B/COM.2/ISAR/16 and Addenda 1–3). While Level 2 SMEs are likely to be economically significant, those at Level 3 constitute the smallest enterprises. This document consists of an accounting and reporting framework, related basic requirements and model financial statements.

SME Guidelines on Accounting and Financial Reporting (SMEGA) for Level 3

II. Conceptual framework

Scope

2. Level 3 enterprises typically have significant difficulties in accessing bank and trade credit. They are likely to be one-person enterprises or businesses with few employees. The SMEGA for Level 3 are intended to meet the needs of users and preparers of financial statements for these enterprises.

Components of financial statements

3. A set of financial statements for Level 3 enterprises includes the following components:

   (a) an income statement; and
   (b) a balance sheet.

Level 3 Accounting framework

4. The two statements – the income statement and the balance sheet – are based on a simple accruals accounting approach broadly consistent with IAS 1. This guidance sets out the accounting and reporting requirements that apply to SMEs in Level 3. The guidance requirements do not involve compliance with IFRS but are based on the historical cost and accruals measurement approach, which is the basis of IFRS. To ensure that the Level 3 financial statements are a part of a coherent framework within the three levels, Level 3 guidance rules are linked with those for Level 2 and IFRS.

5. Level 3 statements will normally be prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future.

The Objectives of Level 3 Financial Statements

6. The objective of Level 3 financial statements is to provide information about the reporting enterprise's financial performance and financial position that will be useful to users in assessing the performance of the enterprise and the stewardship of the enterprise's management.

Users and Their Needs

7. The objective of the proposed financial statements is to help develop the business by providing useful information to users. Therefore, the statements are designed to reflect users needs. Evidence suggests that the principal users are likely to be:

(a) management;
(b) lenders and other creditors:
(c) government;
(d) taxation authorities; and
(e) SME agencies.

8. The following is a summary of the likely needs of these users of annual financial reports of Level 3 enterprises:

Management.

- to confirm how well or badly the enterprise has performed during the year (including the levels of income, costs and revenues);
- for applying for external financing;
- for financial management purposes (e.g. deciding what portion of profits to retain); and/or
- as a tool for succession planning and management of wealth.

Lenders and other creditors:

- to assess risk in the credit decision; and
- to monitor the performance of enterprises that have been given credit.

Government: For macro- and micro-economic planning purposes

Tax authorities: For tax assessment purposes

SME agencies: To assess support requests from enterprises (e.g. grant applications, training requests, subsidized business services)

Qualitative characteristics

9. *Understandability*: It is essential that information provided in financial statements be readily understandable by users.

10. *Relevance*: To be useful, information must be relevant to the decision-making needs of users.

11. *Reliability*: Information is reliable when it is free from material error and bias and can be depended on by users to represent faithfully that which it is said to represent.

12. *Comparability*: Users must be able to compare the financial statements of an entity over time in order to identify trends in the entity's financial position and performance.

13. *Constraints*: The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. Standard setters as well as the preparers and users of financial statements should be aware of this constraint.

14. In practice, trade-offs between qualitative characteristics are often necessary. Determining the relative importance of the characteristics in different cases is a matter of professional judgement.

Elements

15. *Asset*: An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.

16. *Liability*: A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

17. *Equity*: Equity is the residual interest in the assets of the enterprise after all its liabilities have been deducted.

18. *Income* encompasses both revenue and gains. It includes increases in economic benefits during the accounting period in the form of inflows or enhancements of assets as well as decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

19. *Expenses* encompass losses as well as those expenses that arise in the course of the ordinary activities of the entity. Expenses are decreases in economic benefits.

Recognition

20. An item that meets the definition of an element should be recognized if (a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise, and (b) the item has a cost or value that can be measured with reliability.

Measurement

21. The measurement base most commonly adopted by enterprises in preparing their financial statements is historical cost.

22. It is unlikely that Level 3 entities will have the resources to prepare these statements, and therefore the assumption is that the statements will be prepared by an external agency.

Level 3 Enterprises and financial management

23. For day-to-day management of the enterprise, owner-managers will tend to rely heavily on cash flow information. It is widely recognized that the managing of cash is critical to the survival of a business and to managing relationships with banks and other providers of finance. It is recommended that owner-managers keep cash records that will be a source of prime entry for the financial statements. These records, whether produced manually or using a software package, will be an important component in the financial management of Level 3 enterprises.

II. SMEGA Level 3 - Basic Requirements

24. The following details the basic guidance for Level 3 enterprises. For material transactions or events not covered by this guidance, reference should be made to the appropriate requirements in the guidance for Level 2.

25. The minimum set of primary financial statements includes the following components:

(a) A balance sheet; and
(b) An income statement.

26. Enterprises may wish to include other statements that are likely to enhance the overall transparency and quality of the enterprise's provision of information to users.

27. Financial statements should be prepared on a going-concern basis unless management either intends to liquidate the enterprise or cease trading, or has no realistic alternative but to do so.

28. An enterprise should prepare its financial statements under the accrual basis of accounting.

29. The following information should be prominently displayed:

(a) the name of the reporting enterprise; and
(b) the balance sheet date and the period covered by the income statement.

30. Financial statements should be presented at least annually.

31. The enterprise should present current and non-current assets and current and non-current liabilities as separate classifications on the face of the balance sheet.

32. An asset should be classified as a current asset when it:

(a) is expected to be disposed of for cash in, or is held for sale or consumption in, the normal course of the enterprise's operating cycle; or
(b) is held primarily for trading purposes or for the short term and is expected to be disposed of for cash within 12 months of the balance sheet date; or
(c) is cash on hand.

All other assets should be classified as non-current assets.

33. A liability should be classified as a current liability when it:

(a) is expected to be settled in the normal course of the enterprise's operating cycle; or

(b) is due to be settled within 12 months of the balance sheet date.

All other liabilities should be classified as non-current liabilities.

34. As a minimum, the face of the balance sheet should include line items that present the amounts in the formats in Annex 3.

35. Additional line items, headings and subtotals should, if relevant to the enterprise, be presented on the face of the balance sheet.

36. An enterprise should disclose the movement of owner's equity during the financial year.

37. The income statement should follow the structure and use the headings shown in Annex 1.

38. An item of property, plant or equipment should initially be measured at its cost. The cost of an item of property, plant or equipment comprises its purchase price, including import duties and non-refundable purchase taxes, and any directly attributable costs of bringing the asset to working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price.

39. The depreciable amount (cost less expected proceeds from disposal) of an item of property, plant or equipment should be allocated on a systematic basis over its useful life. Straight-line depreciation is the simplest method.

40. Land normally has an unlimited life and, therefore, is not depreciated. Buildings have a limited life and, therefore, are depreciable assets.

41. The financial statements should disclose for each class of property, plant and equipment a reconciliation of the carrying amount at the beginning and end of the period showing:

- additions;
- disposals;
- depreciation; and
- other movements.

42. Lease payments, whether deriving from an operating or finance lease, and payments under hire purchase (HP) contracts should be recognized as an expense (on a cash basis, not on an accruals basis). If the payments are material, the expense should be shown under a specific lease payment heading in the formatted income statement.

43. The value of the lease should not be shown either as an asset or as a liability on the balance sheet. The same approach should be taken for assets acquired under HP contracts.

44. Inventories should be measured at the lower of cost and net realizable value (the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale).

45. The cost of inventories should comprise all costs of purchase and other costs incurred in bringing the inventories to their present location and condition.

46. The cost of inventories should be assigned by using specific identification of the individual costs of items whenever possible. The cost of other inventories should be assigned by using the first-in, first-out (FIFO) or weighted average cost formulas.

47. Revenue should exclude taxes on goods and services but should include commissions receivable.

48. Revenue from the sale of goods should be recognized when the enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods.

49. Revenue from the rendering of services should be recognized to the extent that the service has been provided.

50. Where there is uncertainty as to the receipt of payment for a trade debt, a reasonable provision should be made against trade receivables.

51. Any significant gains or losses should be separately disclosed.

III. Level 3 Model Financial Statements

The Financial statements

52. The two statements – the income statement and the balance sheet – are based on a simple accruals accounting approach broadly consistent with IAS 1. To ensure that the Level 3 financial statements are a part of a coherent framework within the three levels, Level 3 guidance rules are linked with IFRS.

The Costs and Benefits of the Financial Statements

53. The formats take into consideration the cost/benefit issues of Level 3 enterprises. In order to ensure that the statements are useful to owner-managers of typical Level 3 enterprises, the costs of preparing the statements need to be weighed against the benefits to other users and particularly the enterprise itself. For example, potential providers of external financing are likely to require the two financial statements in order to assess the risks involved in the proposed transaction.

Users and Their Needs

54. The objective of the proposed financial statements is to help users extract information that can be helpful in developing the business. Therefore, the design of the statements is intended to reflect users' needs.

Income Statement: Annex 1 and 2

Rationale

55. The structure of the income statement has been designed primarily to meet the needs of owner-managers. It is recognized that the income statement is used by owner-managers to see whether in their pricing they have correctly anticipated the level of costs and profit margins.

56. It is assumed that most enterprises at this level will price goods and services on a cost-plus basis. Thus, the "contribution" reflects the difference between the sales and those costs which the mark-up is calculated on, which are described in the statement as "direct costs".

57. Direct costs will vary from enterprise to enterprise. For example, Annex 2 illustrates an lincome statement for a typical retail business where the mark-up is likely to be made just on purchases. Other types of enterprises may have different definitions of direct costs.

58. The cost structures of enterprises at this level are likely to be very different from those of large businesses. The reason for this is that the majority of these enterprises' costs are likely to be direct. In contrast, the majority of the costs of large businesses are indirect (i.e. related to overhead).

59. The "tax" shown in the income statement relates to the estimated tax due for the year, which relates to the profit or loss for the same year. It therefore follows that the profit after tax and owners drawings/dividends corresponds to the amount shown under the heading "increase/decrease in owner's capital" in the balance sheet in Annex 3.

60. The headings under "indirect costs" will reflect the materiality of the costs in relation to the total indirect costs and their importance with regard to disclosure for users in general. Therefore, there is likely to be some variation among different types of enterprises.

Balance Sheet – Annex 3

61. The relevance of the headings will to a certain extent depend on the nature of the enterprise, but the main structure and headings should be applicable for most enterprises at this level.

Cash flow Statements

62. Historical cash flow statements have been excluded from the set of financial statements at this level because there is little evidence suggesting that users at this level find such statements useful. It is, however, recognized that cash management on a daily basis is critical to the health and survival of enterprises at this level. No prescribed format has been suggested for the keeping of cash records because of variations that may be utilized by different enterprises. For example, some record-keeping systems are paper-based and individualized, whereas others use software packages that prescribe a standard format.

Annex 1

Level 3 Model Income Statement (example)

XYZ Ltd.
Income Statement for the year ended 31 December 20xx

SALES	
Direct Operating Costs	
TOTAL DIRECT OPERATING COSTS	
Contribution	
Indirect Costs	
TOTAL INDIRECT COSTS	
PROFIT BEFORE INTEREST AND OTHER FINANCING COSTS	
Less: **Interest** **Other Financing Costs**	
Profit after Interest and Other Financing Costs	
Less: **Tax**	
Profit after Tax	
Owners' Drawings	
Increase/Decrease in Owners' Capital	

Annex 2

Level 3 Model Income Statement (example)

XYZ Ltd.
Income Statement for the year ended 31 December 20xx

SALES	325,000
Direct Operating Costs	
Opening inventories	30,100
Purchases	195,000
	225,100
Less:	
Closing inventories	32,500
TOTAL DIRECT OPERATING COSTS	192,600
Contribution	132,400
Indirect Costs	
Salaries	34,350
Depreciation	6,500
Lease rent	15,600
Motor vehicle expenses	6,500
Insurance	1,300
Telephone	1,700
Light and heat	1,150
TOTAL INDIRECT COSTS	67,100
PROFIT BEFORE INTEREST AND OTHER FINANCING COSTS	65,300
Less:	
Interest and Other Financing Costs	1,300
Profit after Interest and Other Financing Costs	64,000
Less:	
Tax	8,400
Profit after Tax	55,600
Owners' Drawings	45,000
Increase (Decrease) in Owners' Capital	10,600

Annex 3

Level 3 Model Balance Sheet (example)

XYZ Ltd
Balance Sheet
As of December 31, 20X1
(in USD)

Assets			
Non current Assets			
Property	170,000		
Less: Accumulated Depreciation	40,000	130,000	
Equipment	85,000		
Less: Accumulated Depreciation	25,000	60,000	
Total Non-Current Assets			190,000
Current Assets			
Materials		18,200	
Stock		34,000	
Trade Receivables	28,500		
Less: Provisions	2,500	26,000	
Bank accounts		5,600	
Cash		1,200	
Total current Assets			85,000
Total Assets			**275,000**
Owners' Equity and Liabilities			
Owners' Capital		132,900	
Earnings for the year	55,600		
Less: Drawings this year	45,000		
Increase in Owners Capital		10,600	
Owners' Capital 31 December 20X1			143,500
Non current liabilities			
Loans		105,500	
Current Liabilities			
Bank	2,500		
Taxes Payable	4,600		
Trade Payables	18,900		
Total Current Liabilities		26,000	
Total Liabilities			131,500
Total Owners' Equity and Liabilities			**275,000**